MAILED 12/12/01

**WATER/IRJ***

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

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| Order Instituting Rulemaking on the Commission's Own Motion to Evaluate Existing Practices and Policies for Processing Offset Rate Increases and Balancing Accounts in the Water Industry to Decide Whether New Processes are Needed | **FILED**<br>**PUBLIC UTILITIES COMMISSION**<br>**DECEMBER 11, 2001**<br>**SAN FRANCISCO, CALIFORNIA**<br>**RULEMAKING 01-12-009** |

# ORDER INSTITUTING RULEMAKING

## SUMMARY

Pursuant to our Order in Resolution W-4294, attached hereto as Appendix A and incorporated by reference in its entirety in this Order, the Director of the Water Division was required to prepare for our review this Order Instituting a Rulemaking which we now adopt on our own motion. This Order initiates a proceeding to evaluate existing practices and policies for processing offset rate increases and balancing accounts for water utilities. This proceeding should provide sufficient information about what new or different policies and procedures in the processing of offset rate increases and balancing accounts are needed. Respondents to written inquiries in this proceeding (see Appendix B) are the class A water and sewer system utilities and the Office of Ratepayer Advocates (ORA). Interested parties and all other water and sewer system utilities are not required but are invited to participate in responding to inquiries and commenting on the responses of others.

## INTRODUCTION

The California Public Utilities Commission (Commission) regulates water companies pursuant to the California Constitution, Article XII, Public Utilities Code Section 701 and 2701 et seq., and sewer system utilities pursuant to Section 230.5 and 230.6. In 1976, the Legislature enacted section 792.5 of the Public Utilities Code. It authorized expense offsets and required utilities, upon receiving authorization to pass through the expense costs, to maintain a reserve account reflecting the difference between actual costs incurred by the utility and the revenue collected through the offset rate increase. Offset rate increases traditionally have been authorized to protect utilities from unforeseen expenses of a significant nature over which the utility has no control. Water utilities are regularly authorized offset rate increases and attendant balancing account treatment for unforeseen increases in three expenses areas: purchased power, purchased water and pump tax.

Earlier this year, several water utilities filed advice letters seeking offset rate increases to compensate for recent increases in the costs of purchased power that were not anticipated in the utility district's last general rate case (GRC). ORA protested such a request to increase the rates of 20 districts of California Water Service Company (CWS). ORA claims that: (1) offset rate increases should not be authorized for CWS districts because the utility is over earning (e.g. earning a rate of return (ROR) greater than that authorized in the company's last GRC); and (2) balancing account treatment should not be available to districts that are outside of their rate case cycle (e.g. districts that failed to apply for a GRC when, according to the Rate Case Plan (RCP) adopted in Commission Decision (D.) 90-08-045, or by other Commission order, they had an opportunity to do so).

In response to ORA's protest, CWS acknowledged that the recorded earnings of the company-at-large, and several districts individually, exceed the last rate of return authorized by the Commission but CWS claimed actual earnings was an unfair test. CWS contends that a company's earning status should be measured only by a weather adjusted test such as the pro forma earnings test that is regularly used to determine the eligibility of water utilities for the second test year or attrition year increase that the Commission found to be reasonable in the district's general rate case (GRC) decision.[1] In addition, CWS argued that over-earning was not the only reason that the utility chose not to apply for a GRC upon conclusion of its three-year rate case cycle. Based on the earnings data for the 12 months ending June 30,2001 provided by CWS, of the ten CWS districts outside of their rate case cycle, nine were over-earning on an actual basis. Of the 20 districts for which CWS sought off-set rate increases, 15 districts exceed the authorized rate of return on an actual basis while only ten districts are over earning when the pro-forma earnings test is applied.

ORA replied to CWS noting that while a utility's decision to delay filing a GRC may not always depend on utility over earning, "there is no justification to let utilities book amounts in balancing accounts beyond their rate cycle without any type of review, especially during times of over

[1] In the case of general ratemaking for water, the applicability of weather normalized estimates are incorporated in the development of general rates for the first and second test years and in the application of the pro forma earnings test to determine the utility's eligibility for second test year and attrition year rate increases. Because general ratemaking and the pro-forma test for earnings are both weather-normalized, the pro-forma test generally is perceived as a fairer earnings test than actual recorded earnings. That, however, may not always be the case. Because general ratemaking is conducted prospectively, the utility's revenue requirement relies upon estimates of costs and capital investment expected to occur in the future years for which rates are being set. Estimates, no matter how carefully conceived, are not perfect predictors. While the pro-forma test captures the weather-normalized component of general ratemaking, it is not immune to erroneous estimates. For example, when adopted sales quantities are incorrect, the pro-forma test may not reveal that, but for the erroneous quantities, the utility would be shown as over earning, even on a pro-forma basis. Furthermore, when adopted quantities are stale products of an aged GRC, the pro-forma test's use of those quantities could render the pro-forma test an unreliable measure of utility district earnings.

earnings." As reflected in the table following Appendix B, Part I, earning data subsequently provided to the Water Division reveals that while more than half of the CWS districts have avoided the scrutiny of a regularly timed GRC, in the period from 1996-2000, the utility amassed some 14 million dollars in earnings over and above the rate of return authorized by this Commission. ORA's protest questions the fairness of allowing a utility to obtain dollar for dollar recovery of new electric expenses from ratepayers when the company already has obtained excessive earnings from those same ratepayers who, not incidentally, are also experiencing increased electric expenses in their own homes.

After researching the history, the rationale and the procedures for implementing offset rate relief and related balancing accounts, (as detailed in the attached Resolution 4294), the Water Division staff concluded that: (1) the ORA protest raises issues that the Commission has not previously considered; (2) ORA's two-prong protest raises serious issues that warrant full consideration by the Commission; and (3) the Commission's consideration of ORA's recommendations should not be limited to one utility, but rather, should be considered on an industry-wide basis. We agreed with those conclusions and this rulemaking proceeding is instituted, in part, to test the substance of ORA's protest.

**PRELIMINARY SCOPING MEMO**

This rulemaking will be conducted in accordance with Article 2.5 of the Commission's Rules of Practice and Procedure. As required by Rule 6(c)(2), this order includes a preliminary scoping memo as set forth below.

As provided in Resolution W-4294, the following are the first issues to be considered in this proceeding, which shall be resolved in an Interim Decision:

> The existing procedure for recovery from balancing accounts is as follows: (1) Utilities, at their option, may request a surcharge once under collections reach 2%; (2) Otherwise, balancing account review and recovery of remaining balances are processed at the time of the district's next GRC. Should the Commission revise its existing procedures for recovery of under collections or over collections in balancing accounts that existed prior to, and were suspended on November 29, 2001? If so, what specific procedures should be implemented (A) for districts that are within their rate case cycle and are not over earning either on any basis; (B) for districts that are within their rate case cycle and are over-earning on an actual or on a pro-forma basis; (C) for districts that have stale adopted quantities because they are outside their rate case cycle?

The other issues to be considered in this proceeding are:

> Should the Commission revise its existing rules for obtaining offset rate increases to include consideration of (A) whether the district/utility is outside its rate case cycle? (B) whether the district/utility is over-earning on an actual basis? (C) whether district/utility is over earning on a weather adjusted pro-forma basis?
>
> Should an earnings test be employed to determine whether a district/utility should be allowed to recover all, none, or some portion of under collections in a balancing account? If so, should the test be weather adjusted or actual recorded earnings?
>
> Should offset rate increases and attendant balancing account treatment be available only to the district/utility that has subjected itself to the scrutiny of a GRC and is currently in that rate case cycle?
>
> If a district/utility outside its last rate case cycle is eligible for offset rate increases and attendant balancing account treatment, what calculation should be used to replace the stale adopted quantities from the last GRC?

Pursuant to Rule 6(c)(2), we preliminarily determine the category of this rulemaking proceeding to be quasi-legislative as the term is defined in Rule 5(d).

We intend to consider revising our policies and procedures for authorizing offset rate increases and balancing accounts available to regulated water utilities. At this time, we do not anticipate holding formal hearings.[2] We shall consider holding workshops to be convened by the Water Division if there is an interest in participation. We need not determine at this time whether to hold hearings to receive testimony regarding adjudicative facts.[3] Any party that believes a hearing is required to receive testimony regarding adjudicative facts must make an explicit request following review of materials produced in response to the descriptive questions listed in Appendix B, Part I. Such request should be made in filed comments and must (1) identify the material disputed facts, (2) explain why a hearing must be held, and (3) describe the general nature of the evidence that would be introduced at a hearing. Any right a party may otherwise have to such a hearing will be waived if it does not follow these procedures.

The timetable for this proceeding will depend on the input we receive from the parties. For purposes of addressing the scoping memo requirements, we establish the following tentative schedule which is subject to change by the assigned Commissioner or the assigned Administrative Law Judge (ALJ):

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| December 11, 2001 | Order Instituting Rulemaking |
| December 28, 2001 | Class C and D utilities, and all those interested must file for party status to insure receipt of all filings |
| January 4, 2002 | Utilities Provide Earnings/GRC Data (Appendix B, Part I) |

[2] Under Rule 8(f)(2), "'Formal hearing' generally refers to a hearing at which testimony is offered or comments or argument taken on the record... In a quasi-legislative proceeding, 'formal hearing' includes a hearing at which testimony is offered on legislative facts, but does not include a hearing at which testimony is offered on adjudicative facts." And, under Rule 8(f)(3), "'Legislative facts' are the general facts that help the tribunal decide questions of law and policy and discretion."

[3] Rule 8(f)(1): "'Adjudicative facts' answer questions such as who did what, where, when, how, why, with what motive or intent."

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| January 18, 2002 | Opening Comments-Interim Decision Issues (Appendix B, Part II) |
| February 1, 2002 | Workshops if necessary |
| February 8, 2002 | Reply Comments-Interim Decision Issues |
| March 22, 2002 | Proposed Interim Order |
| March 22, 2002 | Opening Comments –Remaining Issues (Appendix B, Part III) |

Through the scoping memo and subsequent rulings, the assigned Commissioner and the assigned ALJ by ruling with the assigned Commissioner's concurrence, may adjust the timetable as necessary during the course of the proceeding and establish the schedule for remaining events.[4] In no event do we anticipate this proceeding to require longer than 18 months to complete.

Interested parties may file according to schedule, opening comments that respond to the questions set forth in Appendix B to this order, and shall follow the requirements of Rule 14.5, Form of Proposals, Comments, and Exceptions. Pursuant to Rule 6(c)(2), parties shall include in their "Opening Comments Interim Decision Issues" any objections they may have regarding (1) the categorization of this proceeding as quasi-legislative, and (2) this preliminary scoping memo.

Following the receipt of opening comments, the assigned Commissioner will issue a ruling that determines the category, need for hearing, scope, and schedule of this rulemaking (Rules 6(c)(2) and 6.3). The ruling, only as to category, may be appealed under the procedures in Rule 6.4.

[4] The assigned Commissioner's ruling will establish a schedule for comments on the proposed interim order, reply comments on the remaining issues, workshops and workshop reports, discovery and hearings (if any), the issuance of the Draft Decision on remaining issues, and the corresponding comment period.

Commissioner Geoffrey F. Brown and Administrative Law Judge Janet A. Econome are assigned to this proceeding.[5]

**SERVICE LIST**

The possible rule changes to be considered in this Rulemaking could affect all Commission regulated water and sewer service utilities. We will therefore direct that this rulemaking order and its appendices initially be served on all Commission regulated water and sewer service utilities, as well as the Office of Ratepayer Advocates.

After initial service, a new proceeding service list will be formed by the Process office, published on the Commission's Internet site and updated throughout the proceeding. The new service list will *not* automatically include the parties who received service of this order. Only class A and B water and sewer service utilities and ORA will be included automatically on the new service list. Other interested parties, including other water and sewer system utilities who wish to participate, must request to be added to the new service list by submitting a written request or electronic mail request to the Commission's Process Office, stating their full name, the entity they represent, the postal address and telephone number of the person to be served, an e-mail address if they are willing to be served electronically and their desired service list category (Appearance, State Service, or Information Only). All interested parties must notify the Process Office by December 29, 2001 if they expect to be served all documents. Parties serving documents may rely on the

[5] Pursuant to Rule 5(k)(3), the assigned Commissioner is the presiding officer in a quasi-legislative proceeding, except that the assigned ALJ shall act as the presiding officer in the Commissioner's absence at any hearing other than a formal hearing as defined in Rule 8(f)(2).

Internet service list published as of the date their documents must be served or may obtain a copy of the service list by calling the Process Office at (415) 703-2021.

Parties are requested, but not required, to provide an electronic copy of all formal filings to the assigned ALJ. Any common-PC compatible word processing format is acceptable, although WordPerfect or Microsoft Word (any version) is preferred. Submittal may be by e-mail or by including a floppy disk with the ALJ's hardcopy served in accordance with Rule 2.3(a).

**IT IS ORDERED THAT:**

1. A rulemaking on the Commission's own motion is instituted to determine if the Commission should modify the current practice for establishing and maintaining offset rate increases and balancing accounts.
2. This rulemaking is preliminarily determined to be a quasi-legislative proceeding as that term is defined in the Commission's Rules of Practice and Procedure, Rule 5(d).
3. This proceeding is preliminarily determined not to need a formal hearing.
4. The expected timetable for this proceeding is as set forth in the body of this order. The assigned Commissioner by scoping memo and subsequent rulings, and the assigned Administrative Law Judge by ruling with the assigned Commissioner's concurrence, may adjust the timetable as necessary during the course of the proceeding, provided that in no instance shall this proceeding require longer than 18 months to complete.
5. All Class A and B utilities (all utilities with over 2,000 service connections) and the Commission's Office of Ratepayer Advocates shall respond to the assigned questions in the attachments. All other regulated water and sewer service utilities are invited to respond.
6. Pursuant to Rule 6(c)92), parties shall include with their opening comments any objections they may have regarding (1) the categorization of this proceeding as quasi-legislative, (2) the determination not to hold hearings, and (3) the preliminary scoping memo.

7. The Executive Director shall mail a copy of this order to be served upon respondents, all water and sewer service utilities, and the Office of Ratepayer Advocates.
8. After service of this order, the service list for this proceeding shall be formed following the procedures set forth in the Service List section in the body of this OIR.

The Executive Director shall mail a copy of this order to respondents.

This order is effective today.

Dated December 11, 2001, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
RICHARD A. BILAS
CARL W. WOOD
GEOFFREY F. BROWN
Commissioners

**APPENDIX A**

**WATER/IRJ/FLC:jrb**

**PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

**WATER DIVISION** **RESOLUTION NO. W-4294**
**November 29, 2001**

**R E S O L U T I O N**

**(RES. W-4294), ALL WATER AND SEWER SERVICE UTILITIES. ORDER MODIFYING BALANCING ACCOUNT PROTECTION FOR OFFSETTABLE EXPENSES.**

## SUMMARY

This resolution addresses pending and anticipated requests of water and sewer utilities for offset rate relief and balancing account treatment for the offsettable expenses, purchased power, purchased water, and pump tax.

Several water utilities have filed advice letters seeking offset rate relief to compensate for recent increases in the costs of purchased power that were not anticipated in the utility districts' last general rate case (GRC). The Office of Ratepayer Advocates (ORA) protested such a request to increase the rates of 20 districts of California Water Service Company (CWS). ORA claims that: (1) offset rate increases should not be authorized for CWS districts because the utility is over earning (e.g. earning a rate of return (ROR) greater than that authorized in the company's last GRC); and (2) balancing account treatment should not be available to districts that are outside of their rate case cycle (e.g. districts that failed to apply for a GRC when, according to the Rate Case Plan (RCP) adopted in Commission Decision (D.) 90-08-045, or by other Commission order, they had an opportunity to do so).

Water Division staff correctly concludes that because staff processing of advice letter requests is confined, for the most part, to ministerial acts, staff could not determine the substantive factual and policy issues raised by ORA's protest.[1] (See Sacramento Chamber of Commerce v. Stephens (1931) 212 Cal.607, 610; Webster v. Board of Education (1903) 140 Cal. 331, 331.) Instead of simply rejecting advice letter requests subject to the protest, thereby requiring the utilities to seek the offset increases by application, Water Division staff requests Commission consideration of those requests and ORA's protest in this resolution and recommend a reasonable course of action.

After researching the rationale and the procedures for implementing offset rate relief and related balancing accounts, the Water Division staff concludes that: (1) the ORA protest raises issues that the Commission has not previously considered; (2) ORA's two-prong protest raises serious issues that warrant full consideration by the Commission; and (3) the Commission's consideration of ORA's recommendations should not be limited to one utility, but rather, should be considered on an industry-wide basis. We agree.

In this resolution, the Commission orders the Director of the Water Division to submit for our review an appropriate order instituting a rulemaking (OIR). Further, we suspend existing balancing account treatment for all Class A water utility districts that are outside their rate case cycle and institute measures to preserve utility rights to recover under collected, offsettable expenses incurred after this date subject to our determination, today or in the OIR proceeding, of what new procedures, if any, shall apply to recovery of those expenses. Finally, in the interim, we order that offset rate relief requested by advice letter shall be allowed only: (1) for Class A water utility districts that are within their rate case cycle and are not over-earning on a weather normalized means test basis (pro-forma earnings test); and (2) for all other water and sewer utility districts that are not over-earning on an actual or recorded basis.

To provide a meaningful context for this resolution, first we will address CWS's recent advice letter request for offset rate increases and the protests to that request. Thereafter, we will discuss the history of Commission-approved balancing accounts the rate case plan, general ratemaking and the application of the pro-forma earnings test in water utility cases.

## CWS ADVICE LETTER AND PROTEST

Earlier this year, the Commission adopted rate surcharges on electricity rates and authorized rate increases for Pacific Gas and Electric Company (PG&E) and Southern California Edison

[1] Water Division staff has recommended approval of advice letter requests and the Commission has authorized related offset rate increases for smaller water utilities and districts of Class A water utilities that are not subject to the ORA protest – that is, those districts that are within their respective rate case cycle and are not over earning on an actual recorded basis. See for example, Resolutions W-4277, CWS, Bakersfield and Hermosa Redondo Districts; W-4283 Alco Water Service, Salinas District; W-4284 California-American Water Co., Monterey District; W-4288, Garrapata Water Co.; W-4289, Toro Water Service; W-4291, East Pasadena Water Co.; W-4292, Alco Water Service, Normco and Moss Landing Districts; W-4295, Del Oro Water Co., Magalia District.

Company (Edison)[2]. As a result of increased electricity rates authorized by D.01-01-08, D.01-04-005 and D.01-05-064, on May 18, 2001, CWS filed Advice Letter 1493 requesting revision of their tariff schedules in 20 districts to provide an increase in revenues by $5,930,500 or 3.3% to offset their increases in purchased power expenses. The utility noticed customers of this request.

Pearl S. West, representing the Concerned Citizens Coalition of Stockton (CCC) addressed the Commission at its meeting of June 26, 2001. Although the CCC did not formally file a protest to CWS Advice Letter 1493, in her comments to the Commission, Ms. West specifically questioned the process that would be used to increase the rates of customers in CWS's Stockton District.

> "I understand that Cal Water is appealing for another rate increase predicated on an increase in electricity costs. As the owner of ten shares that should please me, but I need to report that my last quarter's dividend had already gone up. The average citizen, facing rising rates for all types of energy cannot pass these increases along to anyone and the questions are two. One, do upward rates ever recede? If so, under what circumstances? and Two, what role can the citizens of California expect the PUC to play in this drama?" (An Appeal to the California Public Utilities Commission, presented by Pearl S. West, Concerned Citizens Coalition of Stockton at 6/26/01 Commission meeting)

On July 6, 2001, ORA filed a late-filed protest to CWS Advice Letter 1493. ORA presented a recorded summary of earnings (12 months ending September 30, 2000) for the 20 CWS districts targeted for rate increases to demonstrate that the combined recorded return shows that CWS is over earning on a company-wide basis, that is, earning a return of 10.21% as compared to the last Commission-authorized return for the company of 8.79%. In addition to requesting that the Commission deny CWS districts offset rate increases, ORA requests that the Commission deny CWS districts, which are outside of their rate case cycles, the benefit of balancing account treatment. To achieve this result, ORA requests that the Commission Order provide the following:

> "Unless authorized by a further order of this Commission, California Water Service Company shall not book any under collections to its balancing accounts for its districts for which it could have but has elected not to file a general rate increase request." (ORA July 6, 2001 Protest, page 2.)

Using CWS's Stockton District to illustrate why ORA's two-prong request is justified, the Protest states:

[2] As a result of these increases, approximately a dozen water companies have filed for offsets. Staff expects that the rest of the approximately 150 water and sewer systems the Commission regulates will also be requesting rate increases.

> "The Stockton District of CWS is a typical example of the over earnings. The last time CWS filed a general rate increase request for its Stockton District was in 1995. Under the three year GRC cycle adopted by Decision 90-08-045, CWS could have filed another GRC request for this district any time after 1997. Apparently CWS has not filed a GRC for this district because it is already earning 11.10%. To now burden customers of the Stockton district (sic) with an additional rate increase is unwarranted."(Ibid. p.1)

CWS responded to ORA's protest by letter dated July 20, 2001. In its response CWS notes that ORA unfairly relies upon actual recorded earnings to show that the company is over-earning instead of using the weather adjusted, pro-forma earnings test. Because rates are set based on long-term average factors to determine water sales, in some years revenues will exceed estimates and in others revenues will be less than estimates. CWS notes that the recorded summary of earnings used by ORA include some of CWS's largest sales months in history and that since then water sales have significantly declined. CWS suggests that use of the weather-normalized means test (pro-forma earnings test) would present a more accurate picture of the company's earning status. Further, CWS acknowledges that in using the pro-forma earnings test, "the Commission has reduced or eliminated certain rate increases when Cal Water is earning over its authorized rate of return. However, the pro-forma earnings test has not been used to reduce or eliminate the recoverability of Cal Water's purchased power or purchased water costs." (CWS July 20, 2001 Response p.2.)

At Water Division staff's request, CWS attached to its July 20 response, a summary of earnings ending June 30, 2001 showing actual recorded earnings as well as calculations derived from the application of the weather-normalized, pro-forma earnings test. This summary shows that of the 20 districts targeted for rate increases, 15 districts exceed the authorized rate of return on an actual basis while only ten districts are over earning when the pro-forma earnings test is applied. Even the CWS June 2001 summary shows that the actual recorded company-wide return of 8.92% continues to exceed but, as CWS states, "is very close to Cal Water's authorized rate of return" of 8.79%. As for the illustrative Stockton District, the CWS June 2001 summary of earnings shows that Stockton continues to over earn on an actual basis (11.08% as compared to ORA's September, 2000 summary of 11.10%). However, Stockton passes the pro-forma earnings test applied to the CWS June 2001 summary, apparently demonstrating that when one considers a weather-normalized earnings test, Stockton does not exceed the utility's last authorized rate of return.

CWS further objects to ORA's request that CWS be prevented from "booking into the balancing account any increase in costs in districts 'for which it could have but has elected not to file a general rate increase request'" as a change in policy that should be addressed in a generic proceeding. CWS points out that not filing for a GRC might be due to factors other than over-earning. CWS notes that "general rate increases are time consuming, costly and contentious" and that "Cal Water may choose not to file… because of community relations or other intangible factors not directly related to rate of return." When it doesn't file for a rate case, CWS claims that the utility has an incentive to operate more efficiently.

Noting that purchased power is the company's "third largest single expense", CWS claims that, if the Commission adopts ORA's recommendation to remove balancing account protection from districts that are outside their rate case cycles, CWS would have to file nine additional rate cases this year or risk the potential loss of between seven and nine million dollars related to the increased cost of purchase power and further risk a possible downgrade in CWS's credit rating[3].

On July 24, 2001, ORA replied to the CWS response. ORA states that the utility provides no documentary support for its suggestion that low rainfall and higher than normal temperatures caused "some of CWS's largest sales months in history" purportedly reflected in the September 2000 summary of earnings used by ORA. ORA also comments that although there are no existing restrictions that limit the use of balancing accounts, similarly, there are no existing requirements that mandate authorization of the rate increase that permits the cost pass-through of offsettable expenses and effectively activates the balancing account. ORA agrees with CWS that a utility's decision to delay filing a GRC may not always depend on utility over earning. However, ORA contends, "there is no justification to let utilities book amounts in balancing accounts beyond their rate cycle without any type of review, especially during times of over earnings." (ORA July 24, 2001 Reply page 2.)

## BACKGROUND

The Edison Case – The History of Balancing Accounts

The steep increase in fuel prices in the early 1970s encouraged the development of ratemaking adjustment mechanisms designed to protect utilities from the financial impact of unforeseen expenses, of a substantial nature, beyond the utilities' management or regulatory control. One such mechanism, the fuel cost adjustment clause, provided an expedited method for utilities to recover expenses related to the rapid changes in the cost of fossil fuel so that the utilities' ability to function would not be impaired, the need for frequent GRCs would be reduced and the utilities' position in the financial community would be enhanced (Re So Cal Edison Co. (1972) 73 Cal. P.U.C. 180, 190.).

By 1975, it became clear that the fuel clause was producing distorted results. Instead of simply reimbursing the utilities' actual fuel costs, on a dollar-for-dollar basis, the clause was producing an unintended windfall that bore no relation to actual utility expenditures. For example, during the period between May 1972 and December 1974, Southern California Edison Company (Edison) repeatedly invoked the clause, raised rates 12 times and by year end, 1974, it had accumulated an over collection of $122.5 million, representing 56% of the company's system wide net income. This net income was 47.8% higher than in the previous year even though 1974

[3] CWS files its GRCs mid-year. We understand that after receiving ORA's Protest, in July 2001, CWS filed a Notice of Intent to seek GRC review for 17 of its districts, including the districts, outside their respective rate case cycles, that are referenced in CWS's July 20 response to ORA's Protest. Apparently eleven of the districts filed for in the NOI are outside of their respective rate case cycle, of which 10 are over earning on an actual recorded basis while four are over earning on a pro-forma means test basis.

sales actually were lower. The Commission modified the fuel clause to insure that utilities did not reap this unanticipated windfall at the expense of ratepayers. The modification was a balancing account entitled the energy cost adjustment clause (ECAC) (Re Investigation Into Fuel Cost Collection Practices of So. Cal. Edison Co. et. al. (1976) 79 Cal. P.U.C. 758 (D.85731) affirmed in Southern Cal. Edison Co. v. Public Utilities Com., (1978) 20 Cal.3d 813 [cited hereafter as the Edison Case]).

The California Supreme Court's decision in the Edison Case is particularly instructive for our purposes. The Court affirmed the Commission's decision establishing ECAC and explained how it effectively corrected the distorted results of the old fuel clause:

> "[T]he commission determined that the cost adjustment concept should be preserved but the clause should be modified to eliminate the defects revealed by experience. The principal such defect . . .was the provision authorizing Edison to base its calculations on a prediction of its fossil fuel needs for the 12-month period following each application for a billing adjustment, premised on the assumption that 'average' weather conditions would prevail throughout that time. The commission abandoned this procedure, and in lieu thereof adopted a clause which operates on a 'recorded data' basis, i.e., on the *actual* fuel expenses incurred by the utility during the period *preceding* its application for a billing adjustment (footnote omitted). The utility is now required to maintain a monthly 'balancing account,' into which it will enter the amount by which its actual energy cost for the month was greater or less than the revenue generated by the clause; and on each occasion hereafter that the clause is invoked, the billing factor will be adjusted so as to bring the balance of this account back to zero. By this device the possibility of large over-or undercollections accumulating in the future is eliminated. And because the commission expanded the clause to include all sources of purchased energy –e.g., nuclear and geothermal, in addition to fossil fuels, it renamed the device the 'energy cost adjustment clause.'" (footnote omitted) (Ibid. at 823, italics in original.)

In its appeal to the Supreme Court, Edison claimed that the company was entitled to keep the massive over collections generated by the old fuel clause because, during the relevant years, the utility's actual rate of return averaged less than the reasonable rate of return authorized by the Commission. Not so, said the Court.

> "First . . .Edison was not entitled to earn a profit on its expenses. Second, even its lawful profit was not guaranteed. A utility is entitled only to the *opportunity* to earn a reasonable return on its investment; the law does not insure that it will in fact earn the particular rate of return authorized by the Commission, or indeed that it will earn any net revenues." (Citations omitted) (Ibid. at 821, footnote 8, italics in the original.)

Edison argued that the rates generated by the old fuel clause were fair and reasonable when authorized. Therefore, the Commission's order requiring Edison to amortize the over collections, by 36 months of billing credit to customers, unlawfully subjected the utility to retroactive ratemaking. Again, the Court disagreed, as it carefully distinguished the Commission's development of "general rates," which are subject to the prohibition against retroactive ratemaking, from charges arising from the fuel clause, which were not the product of general ratemaking:

> "[T]he commission's decision to further adjust those rates so as to compensate for substantial past over collections may well be retroactive in effect, but it is not retroactive *ratemaking.*" (Ibid. at 830, italics in original)

> "Thus the commission was correct in formally finding that the rates fixed by operation of the fuel cost adjustment clause were not 'general rates' but 'extraordinary rates not created by or in a general rate proceeding'; and it was equally correct in concluding therefrom that 'The future reduction of fuel clause adjustment rates is not retroactive ratemaking' even though designed 'to reflect past over- or undercollections.'" (79 Cal. P.U.C. 758, 772, 773)" (Id. at 830, footnote 21.)

Finally, Edison argued that the Commission's abrupt change from the old fuel clause's average-year forecast method to the ECAC recorded method unreasonably disrupted the weather-normalized process by which the old clause, given enough time, would inexorably have balanced over and under collections resulting in net zero.

> "In its petition to this court Edison recognizes that the commission has traditionally made 'the valid historical assumption 'that over a period of years variations from historical average weather conditions will balance out.' And the same petition argues that if the weather cycle were allowed to run its course the present over collections would likewise be balanced out: abnormally wet and warm conditions created this 'temporary differential,' Edison asserts 'and it is only the commission's own decision to shift from an average-year forecast method to a recorded method that will prevent *the averaging out of the effect of the weather conditions on the revenue-expense differential in the long run.*'" (Ibid.) at 825, italics in the original.)

The Court notes that Edison, based on its own argument, had no long term expectation that the company would benefit financially from the fuel clause. Therefore, Edison should not be dismayed by the requirement that it return over collections to customers over a three-year period. That order, says the Court:

> "substitutes a definite credit period of three years in lieu of awaiting the natural completion of the current weather cycle, an event of uncertain date but statistically inevitable occurrence." (Ibid. at 826.)

Balancing Accounts for Water

In 1976, the Legislature enacted section 792.5 of the Public Utilities Code, which authorized expense offsets and required that utilities, upon receiving authorization to pass through the expense costs, maintain a reserve account reflecting the difference between actual costs incurred by the utility and the revenue collected through the offset rate increase. Over the years many water and sewer service utilities have filed for offsets for changes in expenses. Staff has reviewed the filings and generally created resolutions to approve those requests. Whenever such requests are granted, the resulting incremental revenues, and the incremental expense increases, must be booked to a balancing account in accordance with section 792.5.

The Commission first established rules for expense offsets for water utilities in 1977 and further, in 1978, provided rules for maintaining balancing accounts. The 1977 policy[4] described the advice letter offset program for purchased power, purchased water and pump taxes as "similar in concept to the electric Energy Cost Adjustment Clause (ECAC) or to Purchase Gas Adjustment (PGA) in that they allow a utility to recover cost-increases that are generally beyond their immediate control." This policy required that a rate of return, means test be applied to determine a utility's eligibility for the offset program:

> "[c] Traditional tests for offset proceedings be continued. *These require, that with the offset, the rate of return not exceed that last authorized by the Commission and the amount of the offset not exceed the revenue increase.* (sic.)" (June 21, 1977 Memorandum, Major Water Utilities Regulatory Policy, page. 1, italics added.)

On June 6, 1978, the Commission approved "Procedure for Maintenance of Balancing Accounts for Water Utilities." Those procedures did not include application of a means test for use of the offset/balancing account ratemaking treatment. The failure of the 1978 procedures to include a discussion of the rate of return means test is not explained. However, we do know that, for the past several years, the Commission staff has continued to employ the pro-forma earnings test to identify utility over earning. When such over earning is identified, often the utility's implementation of offset rate increases or recoveries of balancing account under collections are delayed (but not denied) until the earnings test shows that the utility is no longer over earning[5].

[4] Memorandum to the Commission from B. A. Davis, Director, Operation Division, Subject: Major Water Utilities Regulatory Policy. Approved at the Commission Conference, June 28, 1977.

[5] Since the Commission decided in D.94-06-033 that, like energy balancing accounts, water utility balancing accounts should accrue interest, the delay in utility recovery of these expenses provides less benefit to ratepayers. For, when utility recovery eventually is authorized, ratepayers have to pay for the under collection and pay the interest on the under collection.

The 1978 balancing account policy, distributed to Class A and Class B water utilities, required that multi-district utilities maintain separate balancing accounts for each district and that each district or utility keep three separate balancing accounts for (1) water production cost offsets, including purchased water and purchased power; (2) ad valorem tax offsets; and (3) all other types of offsets. The balancing account balances were to be amortized at the time of a general rate proceeding. However, the availability of balancing accounts to record the over and under collection of offsettable expenses is continuous. After the balancing account is zeroed out, if increased costs are incurred for an offsettable expense, utilities can immediately begin to record under collections even if no new offset rate increase has been instituted.

> Maintenance of balancing accounts for any given item will start from the date the Commission first authorizes new rates passing through specific changes in cost. This restriction applies only to the first time the cost level for a particular item becomes the subject of an offset, all subsequent changes in cost of that item would be recorded in the balancing account as they occur." (Procedures for Maintenance of Balancing Accounts for Water Utilities (1978) Attachment B, page 1)

For the most part, the 1978 policies are in place today. This means that (consistent with the above quote) every single under collection of expenses, arising from recent electricity cost increases incurred by the water utilities, presently is being preserved in each utility district purchased power balancing account for future recovery. In other words, Water Division staff's inability to process some pending requests for immediate cost pass-through of new purchased power expenses does not constitute denial of those utilities' ability to recover those new expenses. Rather, said recoveries are simply delayed pending Commission resolution of the serious issues raised by ORA's protest.

Although the Water Division staff and the water utilities periodically review the procedures for offset rate increases and balancing account treatment, there have been only two significant occurrences since 1978 – a revised set of procedures issued in 1983, and the Commission's first consideration of balancing account treatment for water companies in a formal proceeding as discussed in D.94-06-033. As clarified in the 1983 procedures, balancing accounts for water record only the incremental change in cost increases incurred and revenues received since the utility's GRC or last offset rate increase. This is quite different from the ECAC, which incorporates all rates established to provide revenue to utilities for fuel costs, offset rate increases as well as rates established in the GRC. All of the revenue received for the fuel expenses are then compared to all bills for fuel incurred to determine the over or under collection in the account. This difference in water balancing accounts appears to underscore the intended temporary nature of the account. It also emphasizes that, different from the ECAC, it is not employed to correct GRC estimate errors, only to provide a dollar for dollar protection to the utility against loss due to unanticipated increases in the offsettable expense. By not using the balancing account to true up the actual costs incurred and the projected expenses estimated in the GRC, the balancing accounts for water emphasize their reliance on the adopted quantities developed in the GRC.

The 1983 revised balancing account procedures addressed the use of GRC adopted quantities. It expressed concern about the use of fallible or unreliable adopted quantities that had been used to develop rates in an old GRC decision and further, it suggested that there is danger inherent in the unscrutinized use of those quantities to calculate contemporary rates:

> "Balancing accounts maintained beyond the latest test year will use the latest adopted quantities. Those cases, where the adopted quantities do not exist or where the latest decision is older than 5 years, will be handled on a case by case basis, by the Commission staff." (Attachment to May 31, 1983 letter to the water utility industry - "Procedures For Maintaining Balancing Accounts for Water Utilities", page 1.)

Adopted quantities are used to estimate the reasonable cost pass-through to be allowed in offset rate increases when a utility experiences new costs in offsettable expenses. In most cases, stale "adopted quantities" are unreliable because they do not accurately reflect or predict the relevant changes in a utility district's conditions since the GRC decision was issued (i.e., changes in the number of customers or changes in customers' use of water as reflected in the number of sales).

Use of unreliable "adopted quantities" in calculating the balancing account or the cost pass-through for offsettable expenses could provide utilities with undeserved income, or an unfair penalty if, as a result, utilities receive either more or less than the reasonable dollar-for-dollar reimbursement of expenses that the Commission intended that this rate adjustment mechanism provide. Of course it can be argued that the very operation of the balancing account will insure that any inequity, either for ratepayers or for the utility, will balance out over time. Even so, it is important that the offset rate increases be calculated carefully to not greatly disadvantage the ratepayers. The utility receives actual currency that it uses while the ratepayers are surrendering their funds in payment. If the ratepayers are charged too much, then the utility actually receives a short-term windfall (as in the Edison Case although on a much smaller scale). The fact that the utility has to pay interest on this over collection windfall is not the same disadvantage to the utility that a ratepayer paying interest on under collections is. Balancing account interest is low. Because the utility receives the offset rate increase, and therefore the money, this short-term windfall revenue, at low interest, is still a cheap source of money that the utility can use to its financial advantage.

Distorted balancing account results caused by use of stale adopted quantities would not be obvious, as it was in the Edison Case, where the unintended windfall was visible and could be verified by simple review of the mathematical calculations that produced the massive over collections in the balancing account. Rather, if use of stale adopted quantities distort balancing account results, as the 1983 balancing account policy apparently expected that it would, the problem can only be revealed by scrutiny of the adopted quantities and comparison of them to the identical component's current, actual quantities in a given utility district.

Since the rate cycle from one GRC application to a Commission decision on the next timely filed GRC application is more than three years, a utility would only need to forego filing a GRC one time to have adopted quantities based on estimates that are over five years old. Notwithstanding the 1983 policy proviso that staff members handle, on a case-by-case basis, the calculation of balancing accounts when the adopted quantities are more than five years old, this apparently does not happen. Staff has been unable to find one case in which the 1983 provision for case-by case processing has been implemented when adopted quantities are stale.[6]

In the early 1990s, the Commission opened an investigation into the financial and operational risks of regulated water utilities (Risk OII) that addressed issues relevant to Class A water utilities including balancing accounts. This is the only formal proceeding that has addressed balancing account treatment for water companies. The Commission decision, D.94-06-033, limited balancing account treatment to purchased water, purchased power and pump tax (groundwater extraction charges). Postage and property tax were removed from the list of offsettable expenses. The Commission also decided that water utilities' balancing accounts should earn interest, as did comparable accounts maintained by energy companies. In the Risk OII, the Commission considered but rejected a utility proposal that a program of complete revenue protection be developed using interest-bearing balancing accounts for all expenses. Although the Commission's decision did not authorize any additional balancing or memorandum[7] accounts, it did address the issue of booking costs to such accounts. It allowed utilities to file applications to book additional water quality costs to the Water Quality Memorandum Account provided the costs were:

> "…unforeseen and therefore were not included in the utility's last general rate case, that the costs will be incurred prior to the utility's next scheduled rate case (or otherwise cannot be estimated accurately for inclusion in a current rate case), and that the expenses are beyond the control of the utility." (D.94-06-033, p. 65)

The Risk OII addressed balancing account issues but the review was not comprehensive. For example, the impact of stale adopted quantities, from old GRC decisions, on the reasonableness of the cost pass-through in balancing account calculations was not considered; nor was the issue of utility over earning, raised by ORA's protest, addressed in the investigation.

[6] In fact, Water Division staff concludes that the 1983 provision could not legally be employed in advice letter requests, the utilities, preferred method of seeking offset rate increases. The development of new adopted quantities, different from those established by Commission decision, is a substantive, discretionary decision, well outside the ministerial tasks that the Commission can delegate to staff.

[7] A memorandum account is distinguishable from a balancing account. Memorandum accounts are initiated by a specific event that might require later rate relief and are established by Commission order. These accounts track targeted expenses , the recovery of which is subject to reasonableness review for both the type and the actual cost of the expense and requires Commission authorization.

General Ratemaking, The Rate Case Plan and the Weather-Normalized Means (Pro Forma) Test for Water Utilities

In 1990, the Commission adopted a rate case plan (RCP) for Class A water utilities in D.90-08-045.[8] Under the RCP, each utility is allocated a time for filing its GRC, generally, once every three years, either in January or July. The RCP for water utilities, like a similar plan for energy utilities, establishes a comprehensive schedule for the processing of rate cases. However, application of the RCPs for water and energy utilities differ in that energy utilities are required to file regularly for a GRC while no such requirement is imposed on water utilities. As noted by the Commission, the RCP for water utilities was intended to promote timely processing of GRCs, to enable the balancing of Commission workload and that of its staff over time, and "to enable a comprehensive Commission review of the rates and operations of all Class A water utilities by providing for the acceptance of general rate cases on a three-year cycle." (D.90-08-045 (1990), Appendix A, page 1.)

Although the RCP establishes a rate case cycle of three years (two test years and one attrition year), water utilities are not confined to that schedule. They may file a GRC application at any time, or not at all.

> "Class A water utilities may file general rate case applications at times other than those provided in the filing schedule determined by Branch, but such applications will not be processed under the time schedules of the RCP unless authorized by Branch. Individual elements of the time schedules may be observed for such applications as appropriate." (Id. at page 1.)

The Risk OII also addressed the filing of GRCs. The Division of Ratepayer Advocates (DRA), predecessor of today's Office of Ratepayer Advocates, proposed that the filing of GRCs every three years be mandatory. Apparently the Commission was unimpressed with what the decision describes as "the DRA witness's suspicion" (as opposed, presumably, to persuasive evidence) that but for the fact that 19 districts filed their GRCs one or two years late, customers would have benefited by a reduction, not an increase, in their rates. The Commission declined to require water utilities to file regular GRC applications.

[8] Prior to the adoption of the RCP, water utilities could file GRC applications at will. In 1979, the Commission implemented the Regulatory Lag Plan an experimental program for scheduling and processing GRCs. The RCP replaced this experimental plan.

The application of a pro-forma earnings test.[9] to determine a water utility's eligibility for GRC rate increases beyond the first test year has been a long-term practice.[10] On October 31, 1985 the Chief of the Water Utilities Branch, Wesley Franklin, sent a letter to all Class A, B and C water utilities promulgating "Guidelines for Normal Rate Making Adjustments in Connection with the Calculation of a Weather Normalized Pro-Forma Rate of Return on Recorded Operation for Water Utilities" (10/30/85). The first sentence on the cover letter read:

> "Since 1982, Commission staff and water utility industry have met on several occasions to discuss the appropriate method for determining the "Pro-Forma" Rate of Return to be used in step rate filings, *offset filings,* and for other earnings reports to the Commission." (emphasis added).

The Risk OII proceeding described application of the pro-forma earnings test to determine eligibility for GRC second test year and attrition year increases:

> "If a utility is authorized to increase rates during the second test year or the attrition third year, the pro-forma test postpones or reduces an authorized increase if in fact the utility already is earning more than its authorized return. A DRA witness explained that if a utility is earning more than its rate case authorization, the pro-forma test does not require a refund. It simply prevents a full step-rate increase when the pro-forma earnings test shows that the utility already is earning more than its authorized rate of

[9] The weather normalized, means test calculates the rate of return (ROR) by using (1) the revenues calculated by adding the actual commercial sales and actual number of residential customers times the already weather normalized number of sales per customer adopted in the last GRC minus (2) the expenses authorized in the last GRC adjusted by the actual number of customers and any approved offsets. These net revenues are divided by the actual rate base to determine the weather-normalized ROR.

[10] Below is a sample of the language contained in the ordering paragraphs of GRC decisions describing how to apply the Pro-Forma Means test:

> "On or after November 6, 2000, CWS is authorized to file an advice letter, with appropriate work papers, requesting the step rate increase for the year 2001 included in Appendix B or to file a proportionately lesser increase for those rates in Appendix B for the Bear Gulch, East Los Angeles, and Visalia districts in the event that a district's rate of return on rate base, adjusted to reflect rates then in effect and normal ratemaking adjustments for the 12 months ended September 30, 2000, exceeds the lower of (a) the rate of return found reasonable by the Commission for CWS during the corresponding period in the then most recent rate decision or (b) 8.79%. This filing shall comply with GO 96-A. The requested step rates shall be reviewed by Water Division to determine their conformity with this order and shall go into effect upon Water Division's determination of conformity. Water Division shall inform the Commission if it finds that the proposed step rates are not in accord with this Decision or other Commission decisions. The effective date of the revised schedules shall be no earlier than January 1, 2001, or 30 days after filing, whichever is later. The revised schedules shall apply only to service rendered on or after their effective dates." (D.99-05-018, Ordering Paragraph 4)

> return at the time the step-rate increase is to become effective." (D.94-06-033, p. 60)[11]

General ratemaking and the pro-forma earnings test reflect the reality that in California, weather conditions directly impact customer use of utility services. For example, in dry years, customers use more water than they do in wet years. As discussed extensively in the Edison Case (supra), it is generally recognized that California's varying weather cycles, over time, balance out. Accordingly, the concept of average year or weather normalized ratemaking is incorporated in the formula employed to develop a utility's revenue requirement from which the Commission derives general rates.

In the case of general ratemaking for water, the applicability of weather normalized estimates are incorporated in the development of general rates for the first and second test years and in the application of the pro forma earnings test to determine the utility's eligibility for second test year and attrition year rate increases. Because general ratemaking and the pro-forma test for earnings are both weather-normalized, the pro-forma test generally is perceived as a fairer earnings test than actual recorded earnings. That, however, may not always be the case.

Because general ratemaking is conducted prospectively, the utility's revenue requirement relies upon estimates of costs and capital investment expected to occur in the future years for which rates are being set. Estimates, no matter how carefully conceived, are not perfect predictors. While the pro-forma test captures the weather-normalized component of general ratemaking, it is not immune to erroneous estimates. For example, when adopted sales quantities are incorrect, the pro-forma test may not reveal that, but for the erroneous quantities, the utility would be shown as over earning, even on a pro-forma basis. Furthermore, when adopted quantities are stale products of an aged GRC, the pro-forma test's use of those quantities could render the pro-forma test an unreliable measure of utility district earnings.

## DISCUSSION

In the instant case, ORA claims that water districts that elected to forego filing a GRC application upon completion of its last authorized, rate case cycle, especially those that are over earning, should not be eligible for offset rate increases and balancing accounts. This Commission has not previously considered this issue. The Commission most frequently renders policy decisions regarding balancing accounts in the context of energy cases. Unlike energy utilities, which the Commission requires to regularly file for GRCs, Class A water utilities are

[11] The Decision also noted that the Means test was probably too complicated for Class B, C and D utilities to calculate and that actual return should be used as the Means test for those utilities.

not required to file for a GRC on a regular basis or at all.[12] Therefore, energy utilities would not confront the problems presented by use of stale adopted quantities from aged GRC decisions to determine the appropriate cost pass-through of offsettable expenses.

Throughout the literature on balancing accounts, the stated purpose of providing this rate adjustment mechanism is to protect utilities from unforeseen expenses of a significant nature over which the utility has no control. If a utility district receives an increase in purchased power costs and that district is not within its rate case cycle, ORA's protests seems to ask, doesn't the utility have the control of promptly filing for a GRC to incorporate the new purchased power expenses? We have seen that CWS did precisely that when, after receiving ORA's protest, it filed its Notice of Intent to seek GRC review of nine districts that were outside their rate case cycle.

We note that in this case, ORA does not request that utilities be required to regularly file GRCs. Rather, ORA believes that when a Class A district fails to do so, it should have to assume the risk of incurring otherwise offsettable expenses. In view of the fact that the RCP allows utilities to file a GRC application at any time, the utility can promptly alleviate its risk by filing an application upon incurring an offsettable rate increase, and thereby experience only the unrecoverable loss of the lag time between the utility's application and the Commission decision.

Offset rate increases and the attendant balancing account treatment limits a utility's recovery of targeted expenses to the reasonable dollar-for-dollar incremental reimbursement of new expenses actually incurred by the utility. Therefore, this ratemaking mechanism does not, in and of itself, cause a utility to earn more than its authorized rate of return. In fact, the recovery of expenses provided by this ratemaking mechanism operates without regard to: (1) whether a utility is otherwise over earning; and (2) whether a utility has timely subjected its overall operations to Commission scrutiny in a GRC when it first had the opportunity to do so. These procedural disregards are fundamental to ORA's protest that, under certain circumstances, the present operation of this ratemaking mechanism is unreasonable and detrimental to ratepayers. ORA suggests that the unrestricted availability of the offset rate increase/balancing account mechanism to water utilities has the unintended effect of perpetuating or promoting a utility's over earning and/or encourages a utility's avoidance of GRC scrutiny by reducing the financial impact of a utility's election to forego the timely filing of a GRC application.

CWS points out that the Commission has not used earnings tests to eliminate the utility's eligibility for balancing account recovery. That is true. However, ORA's protest suggests that the Commission's failure to consider the interaction of an offset rate increase and the utility district's earnings status might promote the approval of unjust and unreasonable rates, especially

[12] One Class A water utility waited over 15 years before it filed a GRC application. Between rate cases, the financial integrity of the utility did not suffer. Despite an antiquated rate structure, the utility was able to maintain financially viability , including a substantial return on its investments because it experienced significant customer growth and was able to offset increased costs in purchased power, purchased water and pump tax by using the advice letter process to obtain offset rate increases.

when the utility is over earning. We have often repeated the U.S. Supreme Court and the California Supreme Court in their statements attesting to the fact that:

> "A utility is entitled only to the *opportunity* to earn a reasonable return on its investment; the law does not insure that it will in fact earn the particular rate of return authorized by the Commission, or indeed that it will earn any net revenues." (Citations omitted) (Southern Cal. Edison Co. v. Public Utilities Com., (1978) 20 Cal.3d 813, 821, footnote 8, italics in the original.)

This Commission has not previously considered the dispute between ORA and CWS over use of the actual recorded earnings as opposed to the pro-forma earnings. The issue of the reliability of stale adopted quantities from an aged GRC has relevance to the application of the pro-forma test as well as to the calculation of the cost pass-through allowed in an offset rate increases. On the other hand, use of the pro-forma earnings test when a utility district is in its rate case cycle does not suffer from the problem of stale adopted quantities. For not only are the adopted quantities fresh but, as CWS points out, in the pro-forma test, increased water sales (a probable reason of over-earning) are estimated using a long-term average process[13]. Using the pro-forma test, the utility will be labeled as over-earning only if customer growth is greater than anticipated, rate base growth is less, or due to changed market forces, the utility's most recent authorized rate of return is less than that authorized at the time of the district's GRC. The Commission has not previously used actual earnings as a standard for denial of a rate increase for Class A water companies. ORA's protest asserts the validity of using actual earnings as the proper indices for determining utility eligibility for the extraordinary rate increases authorized for offsettable expenses. In this argument, ORA punctuates the fact that the utility receives actual earnings – actual dollars – not pro-forma dollars. As is apparent from the discussion of the CWS pro-forma and actual earnings in the Stockton District, the pro-forma earnings is often less than the actual earnings received. As noted on page 4 of this resolution, Stockton passes the pro-forma test indicating that, hypothetically, it is earning less than the authorized rate of return of 8.79% even though the district, in fact, was earning 11.08%, more than 200 basis points greater than the authorized return.

## RECOMMENDATIONS

The Water Division (staff) has evaluated the protest, response and comment and reviewed the history of offsets and balancing accounts. After consideration, staff recommends that the

[13] Using a linear regression program, the actual sales for a particular district are regressed against explanatory variables, such as temperature and rainfall. This results in a mathematical model of that district's usage. To estimate future sales a long-term (30-year) average of temperature and rainfall (for example) are inserted into the model, resulting in the estimate of average (long-term) future sales per customer. Thus, on average, actual sales per customer will be higher than estimated about one-half of the time. (This assumes that there is no underlying influence resulting in continually increasing water sales per customer, such as increased density of swimming polls with time in a district. If this is the case, the above process is inadequate.)

Commission Order the Director of the Water Division to prepare for Commission review, an appropriate Order Instituting Rulemaking (OIR) to evaluate existing practices and policies and determine whether new procedures or policies for processing offset rate increases and balancing accounts should be made and further, to determine whether offsettable expenses and balancing account guidelines should be made permanent, unless changed by later order of the Commission.

Pending further Commission determinations in the context of the OIR, the staff recommends that the Commission preserve the rights of all parties relevant to the issues raised herein by implementing the following recommendations as interim orders:

1) All water companies with existing balancing accounts should, effective the date of this resolution, suspend those balancing accounts and start a new and separate balancing-type memorandum account, (or in the alternative, a memorandum account as specifically ordered below), for each offsettable expense of purchased water, purchased power or pump tax. This will provide the Commission and the utility with a convenient, clear demarcation between the accounting for offsettable expenses from the date that the utilities have notice that the Commission is considering changing rules and policies for allowing offset increases and balancing account processing.
2) The processing of existing balancing accounts (i.e. authorization of a surcharge or a surcredit to dispose of balances) should be determined as a early priority, interim decision in the OIR.
3) Water Division staff should continue to recommend approval of advice letter offset requests by Class A utilities if the utility or district is within its rate case cycle and it is not over-earning on a weather normalized means (pro-forma) test basis. Water Division staff should continue to recommend approval of advice letter offset requests by Class B, C, and D water and sewer utilities that are not over earning on an actual basis. In all such cases, balancing-type memorandum accounts, newly established after the date of this resolution, should be maintained.
4) Water Division staff should continue the established practice of interim rejection and intermittent delay in the processing of advice letter requests for offset rate increases by Class A water companies, or districts that are within the rate case cycle but are over earning on a pro-forma basis. In those cases, to preserve the utility's rights to later recovery of uncollected expenses, consistent with Commission established rules, the utility or district should establish a memorandum account to track the uncollected offsettable expense increases. Staff should process advice letter requests for offset rate increases by such utilities or districts when they are no longer over earning on the pro-forma basis. Upon commencement of receiving the offset revenue, the utility or district should convert the memorandum account to a balancing-type memorandum account where increased expenses and revenues will be tracked.
5) In those cases where Class B, C, and D water and sewer utilities are over earning on an actual basis, Water Division staff should process advice letter requests for offsettable expense increases by including in the earning calculation the ongoing increased expenses

and determining an appropriate offset rate increase that neither perpetuates the utility's existing over earning status nor initiates new over earnings. Utilities shall thereafter maintain a balancing-type memorandum account initiated after the date of this resolution to track new increased expenses and revenues.

6) Consistent with the existing practices and rules, Water Division staff should process advice letter requests by preparing an authorizing resolution submitted for Commission consideration.

7) Water Division staff should reject all advice letter requests for offsets if the Class A utility has elected to forego a timely GRC and therefore, is outside its rate case cycle. Said utilities or districts should book the incremental offsettable expenses incurred after the date of this resolution to a memorandum account to be recovered in its next GRC, subject to any rules established in the OIR. The GRC seeking said memorandum account recovery must be filed within one year from the date of this resolution either, subject to the Rate Case Plan schedule if staff can accommodate such filings, or, by application as provided in the Rate Case Plan, without assured rate case scheduling. Unless otherwise ordered by this Commission, the utility or district will lose all rights to recover from the offsettable expense memorandum account if the utility fails to file for a GRC within the one year time period, unless that period is extended for up to six months by the Executive Director upon a showing of the Office of Ratepayer Advocates that it cannot process the rate case within the statutory 18 month time limit.

## COMMENT

On September 25, 2001, this resolution was mailed or hand delivered to all regulated water and sewer system utilities, ORA, and to the Concerned Citizens Coalition of Stockton for comment. The Water Division (WD) received 9 sets of comments on the proposed resolution W-4294. Comments were received on or before October 15, 2001 from the following Class A water utilities: CWS, San Jose Water Company, Park Water Company (Park), California-American Water Company and Citizens Utilities Company (CalAm), San Gabriel Valley Water Company (San Gabriel), and Suburban Water Systems, from ORA and the California Water Association (CWA). Most comments urged the Commission to reject this resolution and to adopt a more moderate approach beneficial to the utilities. CWA, San Gabriel and Park urged that no change to the existing offset increase/balancing account process be implemented until after the OIR is completed. ORA timely filed comments as well as filed reply comments on October 19, 2001. ORA is the only party that supported the resolution as written, and even ORA asked that it be modified to not delegate advice letter approval to the staff but rather that Commission approval for all offset increases and balancing account recoveries be required. That provision is implemented. All comments were considered and this resolution was modified to include more explicit, clarifying language. Most of the comments would more properly be addressed in the OIR and will be included in the issues that staff raises in the OIR.

## FINDINGS AND CONCLUSIONS

The Commission finds, after investigation by the Water Division, that the procedures authorized herein are justified and that they are designed to protect the rights of all parties relevant to the issues raised. Further, procedures established for the development of offset rate increases and balancing account processing are designed to promote just and reasonable rates and equitable treatment for ratepayers and utilities.

## THEREFORE IT IS ORDERED that:

1. The Director of the Water Division prepare for Commission review, an appropriate Order Instituting Rulemaking (OIR) to evaluate existing practices and policies and determine whether new procedures or policies for processing offset rate increases and balancing accounts should be made and further, to determine whether offsettable expenses and balancing account guidelines should be made permanent, unless changed by later order of the Commission.
2. All water companies with existing balancing accounts shall, effective the date of this resolution, suspend those balancing accounts and start a new and separate balancing-type memorandum account, (or in the alternative, a memorandum account as specifically ordered below), for each offsettable expense of purchased water, purchased power or pump tax.
3. The processing of existing balancing accounts (i.e. authorization of a surcharge or a surcredit to dispose of balances) shall be determined as a early priority, interim decision in the OIR.
4. Water Division staff shall continue to process advice letter offset requests by Class A utilities if the utility or district is within its rate case cycle and it is not over-earning on a weather normalized means (pro-forma) test basis. Water Division staff shall continue to approve advice letter offset requests by Class B, C, and D water and sewer utilities that are not over earning on an actual basis. In all such cases, balancing-type memorandum accounts, newly established after the date of this resolution should be maintained.
5. Water Division staff shall continue the established practice of interim rejection and intermittent delay in the processing of advice letter requests for offset rate increases by Class A water companies, or districts that are within the rate case cycle but are over earning on a pro-forma basis. Staff shall process advice letter requests for offset rate increases by such utilities or districts when they are no longer over earning on the pro-forma basis.
6. In those cases described in paragraph 5 above, unless otherwise ordered by the Commission, the utility or district shall establish a memorandum account to track the uncollected offsettable expense increases until such time that an offset rate increase is authorized. Upon commencement of receiving the offset revenue, the utility or district

shall convert the memorandum account to a balancing-type memorandum account where increased expenses and revenues shall be tracked.

7. In those cases where Class B, C, and D water and sewer utilities are over earning on an actual basis, Water Division staff shall process advice letter requests for offsettable expense increases by including in the earning calculation the ongoing increased expenses and determining an offset rate increase that neither perpetuates the utility's existing over earning status nor initiates new over earnings.
8. In those cases described in paragraph 7 above, utilities shall maintain a balancing-type memorandum account initiated after the date of this resolution to track new increased expenses and revenues.
9. Consistent with the existing practices and rules, Water Division staff shall process advice letter requests by preparing an authorizing resolution for Commission consideration.
10. Water Division staff shall reject all utility or district advice letter requests for offsets if the Class A utility has elected to forego a timely GRC and therefore, is outside its rate case cycle.
11. Utilities or districts described in paragraph 10 above shall book the incremental offsettable expenses incurred after the date of this resolution to a memorandum account to be recovered in its next GRC, subject to any rules established in the OIR. The GRC seeking said memorandum account recovery must be filed within one year from the date of this resolution either, subject to the Rate Case Plan schedule if staff can accommodate such filings, or, by application as provided in the Rate Case Plan, without assured rate case scheduling. Unless otherwise ordered by this Commission, the utility or district will lose all rights to recover from the offsettable expense memorandum account if the utility fails to file for a GRC within the one year time period, unless the period is extended for no longer than six months by the Executive Director upon a showing of the Office of Ratepayer Advocates that it cannot process the rate case within the statutory 18 month time limit with the existing staff resources.

I certify that the foregoing resolution was duly introduced passed, and adopted at a conference of the Public Utilities Commission of the State of California held on November 29, 2001; the following Commissioners voting favorably thereon:

WESLEY M. FRANKLIN
Executive Director

LORETTA M. LYNCH
President

RICHARD A. BILAS
CARL W. WOOD
GEOFFREY F. BROWN
Commissioners

I dissent.

HENRY M. DUQUE
Commissioner

**APPENDIX B**
**PART I**

QUESTIONS

[Part 1, for water and sewer system utilities only]

1. Do you have any full cost balancing accounts? What do they track? How do you book the costs to them?

2. In the last five years: (A) Identify by account the amount of each offset rate increase or decrease for each of your districts, (B) What balancing accounts have you had (utility and district and during what periods were those accounts active?, (C) What were their individual balances on December 31 of each year (including an estimated balance for December 31, 2001), (D) What percent are those balances compared to your annual revenues in that year?

3. With respect to current balances in existing balancing accounts: (A) Which balances exceed 2% of your gross revenues?, (B) If allowed to do so, identify the accounts for which you would seek a surcharge, (C) For each balancing account in each district, identify the date on which you anticipate filing a general rate case in which you expect to obtain amortization of the balance in the account.

4. In the last five years, which years for each district were (or what years were your utility) outside the rate case cycle? Why did you choose not file for a general rate case consistent with the 3-year rate case cycle for each district or your utility?

5. In the last five years (or longer if you wish), in what years was each district (or your utility) over earning on an actual basis? (Please use the attached calculations for California Water Service Company as a guide). After removing debt coverage to derive "Net Regulated Income," what dollar amount and percentage of adopted revenues were you earning in each of those years?

6. In the last fie years (or longer if you wish), in what years was each district (or your utility) over earning on a weather-normalized basis? How much were you over earning (dollar and percentage of adopted revenues)?

7. For each district/utility, identify the number and kind of balancing account(s) in existence on November 29, 2001. What was the total balance (under collections or over collections) in each account?

CALIFORNIA WATER SERVICE COMPANY
1996-2000 OVER-EARNINGS

| Year | "Average Common Equity" (a) | "Net Regulated Income" (b) | "Recorded ROE" (c)=(b)/(a) | "Adopted ROE" (d) | "Recorded Exceeds Adopted ROE" (e)=© - (d) | Over-earnings (f)=(e)*(a) |
|---|---|---|---|---|---|---|
| 1996 | $150,587,500 | $18,721,010 | 12.43% | 10.30% | 2.13% | $3,210,498 |
| 1997 | $159,145,500 | $22,815,940 | 14.34% | 10.35% | 3.99% | $6,344,381 |
| 1988 | $166,434,500 | $17,957,810 | 10.79% | 10.35% | 0.44% | $731,839 |
| 1999 | $170,597,500 | $18,634,240 | 10.92% | 9.55% | 1.37% | $2,342,179 |
| 2000 | $182,660,000 | $19,717,090 | 10.79% | 9.95% | 0.84% | $1,542,420 |
| TOTAL 1996-2000 | | | | | | $14,171,316 |

Note: (1) The figures in columns (a), (b) and (d) were provided by CWS and are not audited.
(2) The figures in columns (c) and (e) are calculated and identical to calculated figures provided by CWS.

CALIFORNIA WATER SERVICE COMPANY
1975-2000 OVER-EARNINGS

| Year | "Average Common Equity" (a) | "Net Regulated Income" (b) | "Recorded ROE" (c)=(b)/(a) | "Adopted ROE" (d) | "Recorded Exceeds Adopted ROE" (e)=© - (d) | Over-earnings (f)=(e)*(a) |
|---|---|---|---|---|---|---|
| 1976 | $51,472,294 | $5,749,016 | 11.17% | 12.30% | No | ($582,076) |
| 1977 | $53,570,316 | $5,222,956 | 9.75% | 12.78% | No | ($1,623,330) |
| 1978 | $55,412,912 | $5,827,588 | 10.52% | 12.81% | No | ($1,270,806) |
| 1979 | $57,533,903 | $6,546,332 | 11.38% | 13.00% | No | ($933,075) |
| 1980 | $59,985,758 | $7,084,220 | 11.81% | 13.20% | No | ($833,900) |
| 1981 | $63,246,000 | $8,876,620 | 14.04% | 13.70% | 0.34% | $211,918 |
| 1982 | $66,424,000 | $7,700,460 | 11.59% | 14.50% | No | ($1,931,020) |
| 1983 | $69,362,500 | $9,196,720 | 13.26% | 14.50% | No | ($860,842) |
| 1984 | $73,981,500 | $11,447,940 | 15.47% | 14.50% | 0.97% | $720,623 |
| 1985 | $79,815,000 | $12,328,240 | 15.45% | 14.50% | 0.95% | $755,065 |
| 1986 | $85,947,000 | $13,555,640 | 15.77% | 14.25% | 1.52% | $1,308,193 |
| 1987 | $93,822,000 | $17,060,840 | 18.18% | 13.00% | 5.18% | $4,863,980 |
| 1988 | $101,976,000 | $13,973,720 | 13.70% | 13.00% | 0.70% | $716,840 |
| 1989 | $107,682,000 | $13,383,400 | 12.43% | 12.25% | 0.18% | $192,355 |
| 1990 | $112,086,500 | $13,987,260 | 12.48% | 12.25% | 0.23% | $256,664 |
| 1991 | $116,011,500 | $13,705,280 | 11.81% | 12.25% | No | ($506,129) |
| 1992 | $118,676,500 | $12,430,980 | 10.47% | 12.25% | No | ($2,106,891) |
| 1993 | $121,786,500 | $15,345,390 | 12.60% | 11.25% | 1.35% | $1,644,409 |
| 1994 | $134,223,000 | $14,244,410 | 10.61% | 10.20% | 0.41% | $553,664 |
| 1995 | $145,698,000 | $14,260,240 | 9.79% | 11.05% | No | ($1,839,389) |
| 1996 | $150,587,500 | $18,721,010 | 12.43% | 10.30% | 2.13% | $3,210,498 |
| 1997 | $159,145,500 | $22,815,940 | 14.34% | 10.35% | 3.99% | $6,344,381 |
| 1988 | $166,434,500 | $17,957,810 | 10.79% | 10.35% | 0.44% | $731,839 |
| 1999 | $170,597,500 | $18,634,240 | 10.92% | 9.55% | 1.37% | $2,342,179 |
| 2000 | $182,660,000 | $19,717,090 | 10.79% | 9.95% | 0.84% | $1,542,420 |
| TOTAL 1996-2000 | | | | | | $12,907,566 |

Note: (1) The figures in columns (a), (b) and (d) were provided by CWS and are not audited.
(2) The figures in columns (c) and (e) are calculated and identical to calculated figures provided by CWS.

**APPENDIX B**
**PART II**

[Part II, for all respondents Interim Decision Issues]

The existing procedure for recovery from balancing accounts is as follows: (1) Utilities, at their option, may request a surcharge once under collections reach 2 per cent; (2) Otherwise, balancing account review and recovery of remaining balances are processed at the time of the district's next GRC.

1. Should the Commission revise its existing procedures for recovery of under collections or over collections in balancing accounts that existed prior to, and were suspended on November 29, 2001? Why or why not?

2. If your answer to Part II, Question Number 1 is yes, what specific procedures should be implemented:

   (a) for districts that are within their rate case cycle and are not over earning?

   (b) for districts that are within their rate case cycle and are over-earning on an actual or on a pro-forma basis?

   (c) for districts that have stale adopted quantities because they are outside their rate case cycle?

**APPENDIX B**
**PART III**

[Part III, for all respondents]

1. Should any expenses be offsettable? Why?

2. What specific expenses should be offsettable? Why?

3. For each expense that should be offsettable, should the expense offset rate increase be subject to an earnings test? Why or why not?

4. If they should undergo an earnings test, what should the test be? Why?

5. What should the impact of over earning be on the utility's recovery – disallow or just delay? Why?

6. Accepting the distinction that balancing accounts may be carried on the utility's books and that memorandum accounts are not carried on the utility's books until they have been approved for recovery, should the offset revenues and expenses be tracked in a balancing account or should they be tracked in a memorandum account? Does Public Utilities Code Section 702.5 require a balancing account or would a memorandum account work just as well? Why?

7. If they are tracked in a balancing account, should there be any earnings test limits on recovery? Why?

8. If there should be such a test, what should the test be? Why?

9. What should the impact of over earning be on the utility's recovery – disallow or just delay? Why?

10. Should there be an earnings test on memorandum account recovery? Why?

11. If there should be such a test, what should the test be? Why?

12. What should the impact of over earning be on the utility's recovery – disallow or just delay? Why?

13. Should a utility (or district) outside the rate case assume the risk of all expense changes, including cost changes for purchased water, purchased power and pump tax? Thoroughly explain your answer.

14. Should an earnings test be applied to offset rate change requests when the utility or district is outside its rate case cycle? Why or why not?

15. If there should be such a test, what should the test be? Why?

16. What should the impact of over earning be on the utility's recovery – disallow or just delay? Why?

17. Should water and sewer service utility be required to file general rate cases? If yes, how often? Why? Should there be an opportunity to appeal to delay filing for good cause? If so, what circumstances would constitute good cause?

18. Should the Commission consider different policies on balancing accounts and treatment of offsettable expenses for non-class A water and sewer service companies?

19. If an earnings test should apply to offset increases or balancing account recovery, what earning period should be used (prior 12 months? calendar year?) Why?

20. If over earning requires disallowance, then how much should be disallowed (just the amount over earned? the entire expense)? Why?

21. Should utilities be required to file for rate changes when offsettable expense changes occur? If so, how close to the time of the expense change should they be required to file?

22. If the result of failing the earnings test should be a delay in filing, how long should the delay be?

23. If the result of failing the earnings test is a disallowance of balancing account recovery or is a limitation in the offset rate increase, and the result is a reduction in the utility's actual rate of return, should there be a limit (a "floor") on the return that would trigger reconsideration of the disallowance? Why?